IN THE HIGH COURT OF JUDICATURE AT MADRAS

DATED: 08/12/2003

CORAM

THE HON'BLE MR.JUSTICE R.JAYASIMHA BABU
and
THE HON'BLE MR.JUSTICE S.R.SINGHARAVELU

T.C.No.249 of 1998 and T.C.No.277 of 1998

The Commissioner of Income Tax,
Central-I,
Chennai. ..Applicant

-Vs-

M/s Associated Electrical Agencies,
Chennai. ..Respondent
in T.C.No.249/98

M/s (Hydrabad),
Chennai. ..Respondent
in T.C.No.277/98

Tax Case reference under Sec.256 (2) of the Income-tax Act, 1961, against the order of the Income-tax Appellate Tribunal, 'C' Bench, Madras, dated 30.1.1997, made in R.A.Nos.273 & 274/Mds/97 in ITA Nos.128 & 129/Mds/1996.

!For Applicant : Mrs.Pushya Sitaraman,
Sr. Standing Counsel
for I.T. Department.

^For respondent : Mr.V.Ramachandran,
Senior Counsel
for Mr.Devendiran

:JUDGMENT

(Delivered by R.JAYASIMHA BABU, J.)

The assessment year is 1992-93. The questions referred to us for consideration are:-

"1. Whether on the facts and in the circumstances of the case, the Appellate Tribunal was right in law and had valid material in coming to the conclusion that the advertisement expenses claimed to have been shared by the assessee with M/s Dynavision Ltd. and the difference in purchase price

claimed by the assessee are in the nature of a contractual obligation and are, accordingly, allowable as expenditure incurred by the assessee for the Assessment year 1992-93?

2. Whether on the facts and in the circumstances of the case and having regard to the Supreme Court's decision in the case of Mc Dowell & Co. Ltd. (154 ITR 148) the Appellate Tribunal was right in law in failing to appreciate that the expenditure claimed by the assessee was only a device to avoid tax on income earned by the assessee?"

3. The two assessees are agents of a company Dynavision (hereinafter referred to as 'the company'), which manufactured television sets. According to the assessees, 70 per cent of the production of that company was marketed through them. The company was promoted by persons whose relatives are partners in the two assessee firms. However, the majority of the shares in that company are not held by those promoters. Substantial part is held by the public sector companies and a large part by private shareholders, and about 26% by the promoters. The managing Director of the company belongs to the promoters group. Several officers of the State Government are on the Board of this Company.

4. For the assessment year 1992-93, when the returns filed by these assessee were taken up for scrutiny, the assessing officer noticed certain amounts having been shown as credited to the account of the company. Pursuant to enquiries made by the assessing officer, the assessees produced a letter dated 20.3.1992 received by them from the said company and addressed to one of the assessees with a copy thereof marked to the other. That letter is signed by the Managing Director of the company. The caption of that letter is "Sharing of marketing expenses and revision of price for the year 1991-92". That letter, after referring to some earlier communications stated to have been sent to the assessees, records the fact that the television market was in a recessionary trend; that sales and margins were under great strain and that the assessees had appreciated that it would not be appropriate to cut down the advertising and marketing expenses in view of the competition getting tougher in the declining market and, accordingly, the assessees had agreed, having regard to the past mutual benefits that they had obtained from the compan y, to share the financial strain that the company was facing. The manner in which that strain was to be shared as set out in that letter was that the assessee Associated Electrical Agencies would share 25% of the advertisement expenses, the assessee Apex Agency (Hydrabad) 25% and the company itself meeting the balance 50%. The travelling and conveyance expenses incurred by the marketing staff was also to be shared in the ratio of 30% each by the two assessees and the balance 40% by the company. The salaries paid to the marketing staff were to be met out of the contribution agreed to be made by the two assessees in the sum of Rs.2,37,500/- p. m. each.

5. The letter also records the agreement said to have been reached earlier with the assessees that the assessees would pay an additional price of Rs.50/- per set for 14" Black & White TV sets and Rs.175/- for 20" black and White TV sets. The assessees, in addition to placing reliance on that letter and asserting that what was stated in that letter was indeed the record of an

agreement which had been reached earlier and had been accepted by the two assessees, also relied on the fact that they had made debit entries on 31.3.1992 for the sums which corresponded to the sharing arrangement set out in that letter.

6. As the assessees followed mercantile system of accounting, they had claimed the amounts shown in their books of entry as having been credited to the account of the company in accordance with the contents of that letter of 20.3.1992, as expenditure for that year.

7. The assessees had also produced before the assessing officer the debit notes issued by the company on 30.4.1992 for these sums. The sums in case of the assessee, Associated Electrical Agencies, are Rs.72,28,025/- towards marketing expenses and Rs.45,11,700/- towards the difference in price for the TV sets. In the case of Apex Agencies (Hydrabad), the sums are Rs.72,28,025/- towards marketing expenses and Rs.22,74,075/- towards the difference in price for the TV sets.

8. The assessing officer, while accepting that the assessees maintained their books on mercantile system was, nevertheless, of the view that this was a post-accounting exercise undertaken solely for the purpose of reducing the taxable profit of the assessees and that the letter, dated 20.3.1992, issued by the company was not capable of being regarded as an agreement under which an enforceable liability was cast on the assessees. He, therefore, disallowed the sums, as a consequence of which, the taxable profit of the assessees went up substantially. On appeal, the Commissioner upheld the view of the assessing officer.

9. On further appeal to the Tribunal, the Tribunal after noticing the fact that of the six directors of the Company, three did not belong to the promoter group; that the Chairman of the company was an officer belonging to the Indian Administrative Service; that the pattern of share holding in the company among the Tamil Nadu Industrial Development Corporation (TIDCO), the group of P.Obul Reddy, the promoters, and the public was 26:26:48; that the composition of the two assessee firms, which included the promoter P.Obul Reddy in one firm in his individual capacity and in the other as representative of HUF, one of the firms also having the Managing Director of the Company as a partner in his capacity as the Manager of HUF, held that despite the intimate linkage between the Managing Director and one of the Directors and the two firms in which they were also partners either individually or as representing the HUF, the other partners being the members of their family, the agreement recorded in the company's letter, dated 2 0.3.92, followed by the firms making credit entries in favour of the company in their books could not be regarded as unreal transaction or one undertaken solely for the purpose of reducing the taxable profit of the two assessees.

10. The Tribunal also took note of the fact that the production and sales volume of the company had steadily gone down and that the company's finances were poor and held that the arrangement which was recorded in that letter of 20.3.1992 was one which was meant to equitably distribute a part of the burden borne by the company among the company and the two distributors.

The bulck of the business run by the two assessees was only in relation to the product manufactured by the company and the two assessees, therefore, had a vital interest in the continued functioning of that company.

11. The Tribunal ultimately held that on applying the test as to whether the expenditure had been incurred wholly or partly or exclusively for the purpose of the assessee's business it was necessary to find out as to whether the assessees were acting reasonably in the interest of their own business. The Tribunal accepted the assessees' case that they were indeed acting in the interest of the business, as their business was primarily that of acting as agents for the sale of the products manufactured by the company, and by agreeing to share any sum of the expenditure which was necessary for the company to incur for promoting the products manufactured by it and marketed by the assessees they were in effect advancing the cause of their own business. It also accepted the assessees' claim that the expenditure incurred was commercially expedient for the assessees. It also accepted the assessees' case that the expenditure in fact had been incurred as necessary entries had been made in the books of account.

12. The Tribunal also took note of the fact that these amounts had been shown in the books of account of the company and that there had been no disallowance of expenditure by the assessing officer. The Tribunal concluded with the finding that the expenses as claimed by the assessees were allowable as they were incurred indirectly to facilitate the carrying on of the business or to preserve their existing source of income with a view to safeguarding the business and also increasing their profits in future.

13. It was submitted before us by the learned counsel for the Revenue that what has been done by the assessees is merely a paper exercise with a view to reduce their own tax burden and they have merely taken advantage of the fact that the company was engaged in the production of a product, which it was not possible to market with the same degree of ease as was being done earlier on account of technological changes and more entrants having entered the market. It was submitted that when the assessees found at the end of the year that they had substantial profit which would attract a large tax liability, one of the partners who also happened to be the Managing Director of the company had sent a letter in the name of the company and even the debit notes sent by the company were only sent after the end of the accounting year and that there was in fact no liability at all on the assessees and there was certainly no need what ever for them to make payment of these sums to the company about which payment also admittedly there was no proof.

14. For the assessees it was submitted by the learned Senior Counsel that the business of the assessees was closely linked with that of the company; and that there was nothing surprising in the two assessees agreeing to bear a part of the expenditure which was required to be incurred and had been incurred to promote the sale of the product with a view to expand the market and the sale, as the bulk of the sales effected by these two assessees were only the television sets manufactured by the company. It was stressed by learned counsel that these assessees would not stand to gain in any manner by parting with their valuable funds to the company when there was no prospect of

that money coming back to them so as to result in a benefit consequent to their having to pay tax in a lesser sum. The company to which the payment was made being a public company, 48% of it's shares being held by the public and the Government corporation holding 26%, no business man, it was submitted, if he is prudent, would part with his money to a company 74% of whose shares was in the hands of others, unless such payment was regarded by him as being commercially expedient.

15. Learned counsel also placed before us a statement showing the payments made by the assessees to the company in the subsequent year at the end of which it was the company which owed monies to the assessees although at the commencement of the year the assessees owed a substantial sum to the company.

16. The reasons given by the Tribunal for taking the view that it did cannot be said to be arbitrary or irrational, having regard to the facts available on record. It was not the case of the Revenue that any part of the monies agreed to be paid by the assessees to the company and for which sums credit had been given in the books of the assessees have subsequently come back to the assessees in any other manner. While it is no doubt true that there was no legal compulsion on the assessee to agree to pay the sums which are mentioned in the letter of the Managing Director of the company, there was also no legal bar to their agreeing to pay higher price for supplies already received if they felt that it was in their long term interest to pay such a higher price. It was also open to them to agree to bear a part of the advertising and marketing costs as those costs were incurred with a view to enlarge the market and to improve the sales. Sales effected of the company's product resulted in benefits to the assessees as they were the selling agents for the company.

17. This is not a case where the company to which credit was given by the assessees was completely owned or controlled by the partners of the assessee firms although there is clearly a linkage between the two, inasmuch as two of the directors are partners in these firms and the other partners are their relatives. There is no material to show that any part of the amounts shown to have been credited to the company under this arrangement subsequently came back to these firms.

18. In the statement setting out the particulars of payments made by the assessees to the company as also the amounts that were due to the company during the subsequent year which statement was filed before us reference is made to credit notes. Learned counsel for the assessees raised doubts as to what those credit notes represent. It is not necessary for us to go into the details of the accounts of the subsequent year as those questions would arise in the assessment for the subsequent year. What is evident from the figures now placed before us is that payment appears to have been made of the amounts for which the credit was given in favour of the company on 31.3.1992 in terms of the contents of the letter of 20.3.1992.

19. Payments made, having regard to the commercial expediency, need not necessarily have their origin in contractual obligations. If the

assessee, which carries on a business finds that it is commercially expedient to incur certain expenditure directly or indirectly, it would be open to such an assessee to do so notwithstanding the fact that a formal deed does not precede the incurring of such expenditure. While the company in this case may have had difficulty in compelling the assessee to make payments solely on the basis of that letter of 20 .3.1992, once the assessees accepted and acted in accordance with what was set out in that letter, the assessees cannot be faulted for having agreed to something which had been set out as a record of a prior agreement, in a letter written to them by the company.

19. Having regard to all these facts, the Tribunal cannot be said to have erred in the view that it took. The question referred are answered in favour of the assessees and against the Revenue.

Index: Yes
Website: Yes

To

1.The Assistant Registrar,
Income Tax Appellate Tribunal,
Rajaji Bhavan,
III Floor, Besant Nagar,
Madras-90. (with records) (5 copies)

2.The Secretary,
Central Board of Revenue,
New Delhi. (3 copies)

3.The Commissioner of Income Tax,
Central-I,
Madras.

4.The Commissioner of Income-tax,
(Appeals)-I, Madras.

5.The Addl. Commissioner of Income-tax,
Central R-Ii, Madras.

6.The Asst. Commissioner of Income-tax,
Central Circle-Ii (1, Madras.

Dev/